

SURFACE TRANSPORTATION BOARD

DECISION

STB Ex Parte No. 664

METHODOLOGY TO BE EMPLOYED IN DETERMINING THE RAILROAD
INDUSTRY'S COST OF CAPITAL

Decided: November 27, 2007

In a decision served on August 14, 2007, the Board issued a Notice of Proposed Rulemaking (NPRM) seeking public comments on a proposal to revise its method for calculating the railroad industry's cost of capital by computing the cost of equity using a capital asset pricing model (CAPM).

A hearing on this matter is scheduled for December 4, 2007 at 10:00 a.m. Any party of record wishing to speak at the hearing was instructed to file with the Board by November 20, 2007, a notice of its intent to participate and to identify the topics to be covered. The schedule of appearances and the time provided for each party appear in the Appendix to this decision. The Board will have read the written submissions in advance of the hearing. Witnesses should not read their written submissions at the hearing, but instead should summarize their key points.

To further focus the hearing, the consultant witnesses in Panel II (and any other witnesses who may wish to do so), are invited to address in their oral remarks on December 4, 2007, the following issues raised in the public comments. They may address other topics identified in their written testimony, but should be mindful that the Board has studied the public comments in depth.

- **CAPM**

- 1) Risk-Free Rate: To calculate the risk-free rate, the Board proposed to use the 10-year Treasury Bond rate. NPRM at 10. If it ultimately decided to use a CAPM model, should the Board instead use the 3-month Treasury Bond rate, and if so, why?
- 2) Market-Wide Risk Premium: To calculate the annual market-wide risk premium, the Board proposed to use monthly New York Stock Exchange (NYSE) data for a 50-year time period. NPRM at 10. In an effort to capture the best evidence of investors' expectations as to the market-wide risk premium,

should the Board use a longer period (looking as far back as there is reliable NYSE data)?

- 3) Beta: To calculate the measure of systematic, non-diversifiable risk of a particular carrier (Beta), the Board proposed to use that carrier's monthly, merger-adjusted stock returns for the prior 10 years. NPRM at 10. Should it instead use a shorter period of 5 years to calculate Beta, and if so, why? Address the criticism that a 5-year period would introduce undue volatility in the cost-of-equity calculation.

- **Multi-Stage Discounted Cash Flow (DCF)**

- 1) In the NPRM, the Board proposed not to use a multi-stage DCF model because it could not find a reasonable way to select the time period over which to phase down from the initial growth rate to the long-term growth rate for the economy. NPRM at 5. Numerous parties have asked the Board to reconsider, arguing that the multi-stage DCF can provide useful evidence of the cost of equity. If the Board reconsiders and elects to use a multi-stage DCF model, please comment on the 10-year phase-in period proposed by Western Coal Traffic League.
- 2) Please also discuss how best to estimate the long-term growth potential for the railroad industry.
- 3) In its single stage model, the Board has used the factor $(1+g/2)$ to account for annualized growth in dividend yields. If the Board employs a multi-stage DCF that explicitly permits the dividends to grow each year at varying rates, is it necessary to include the factor $(1+g/2)$?

- **Using Both CAPM and Multi-Stage DCF**

- 1) The United States Department of Transportation (USDOT) has suggested that the Board use an average of the results of the CAPM and Multi-Stage DCF models to estimate the cost of equity. There also appears to be a robust economic literature on the value of averaging multiple estimates to reduce volatility. If the Board adopts this proposal, should it retain the discretion in the annual cost-of-capital proceedings to modify either model (or to rely on the result of just one model) or, in the interests of transparency and predictability, should it commit to using the average of the two models adopted in this rulemaking?

- 2) If the Board provides for some discretion in how to apply these two models in the annual cost-of-capital determination, how stringent a standard of proof should the Board demand before it departs from the average of the two models or from whatever assumptions are ultimately adopted in this rulemaking (e.g., whether to use of the 10-year or 3-month Treasury Bond rate to calculate the risk-free rate for CAPM)?

If a party wishes to enhance its presentation by using projector-adaptable visual displays and/or handouts, it may do so. Staff will be available to demonstrate the hearing room's projection system on December 3, 2007, from 2 p.m. to 4 p.m. Please call (202) 245-0245 to make arrangements.

Instructions for Attendance at Hearing

The STB requests that all persons attending the hearing use the Patriots Plaza Building's main entrance at 395 E Street, S.W. (closest to the northeast corner of the intersection of 4th and E Streets). There will be no reserved seating, except for witnesses. The building will be open to the public at 7:00 a.m. and participants are encouraged to arrive early. There is no public parking in the building.

Upon arrival, check in at the 1st Floor security desk in the main lobby. Be prepared to produce valid photographic identification (driver's license or local, state, or federal-government identification); sign-in at the security desk; receive a hearing room pass (to be displayed at all times); submit to an inspection of all briefcases, handbags, etc.; then pass through a metal detector. Upon entering the hearing room, witnesses should check in with the Board Secretary. Persons choosing to exit the building during the course of the hearing must surrender their hearing room passes to security personnel and will be subject to the above security procedures if they choose to re-enter the building. Hearing room passes likewise will be collected from those exiting the hearing upon its conclusion.

Quiet laptops and tape recorders may be brought into the hearing room, but no provision will be made for the connection of personal computers to agency telephone lines. Cellular telephone use is not permitted in the hearing room; cell phones may be used quietly in the corridor surrounding the hearing room, or in the building's main lobby.

The Board's hearing room complies with the Americans With Disabilities Act, and persons needing such accommodations should call (202) 245-0245, by the close of business on December 3, 2007.

This action will not significantly affect either the quality of the human environment or the conservation of energy resources.

It is ordered:

1. Time for the hearing is allotted as reflected in the Appendix to this decision.
2. This decision is effective on the date of service.

By the Board, Vernon A. Williams, Secretary.

Vernon A. Williams
Secretary

APPENDIX
SCHEDULE OF APPEARANCES

December 4, 2007

<u>Party</u>	<u>Time Allotted</u>
Panel I: Federal Government	
U.S. Department of Transportation Federal Railroad Administration Clifford C. Eby	5 minutes
Panel II: Consultants	
Association of American Railroads Stewart C. Myers and Bruce E. Stangle	30 minutes
Western Coal Traffic League Thomas D. Crowley and James E. Hodder	30 minutes
Panel III: Freight Railroads	
Union Pacific Railroad Company James R. Young	5 minutes
BNSF Railway Company Thomas N. Hund	5 minutes
CSX Transportation, Inc. David A. Boor	5 minutes
Kansas City Southern Railway Company Michael K. Borrows	5 minutes
Norfolk Southern Railway Company William J. Romig	5 minutes
Panel IV: Other Interests	
Atticus Capital LLP Heath Watkin	5 minutes

Panel V: Associations

Association of American Railroads G. Paul Moates	10 minutes
National Industrial Transportation League Nicholas J. DiMichael	5 minutes
Western Coal Traffic League Robert D. Rosenberg	10 minutes